Briefing
Office sector

Q1 2015

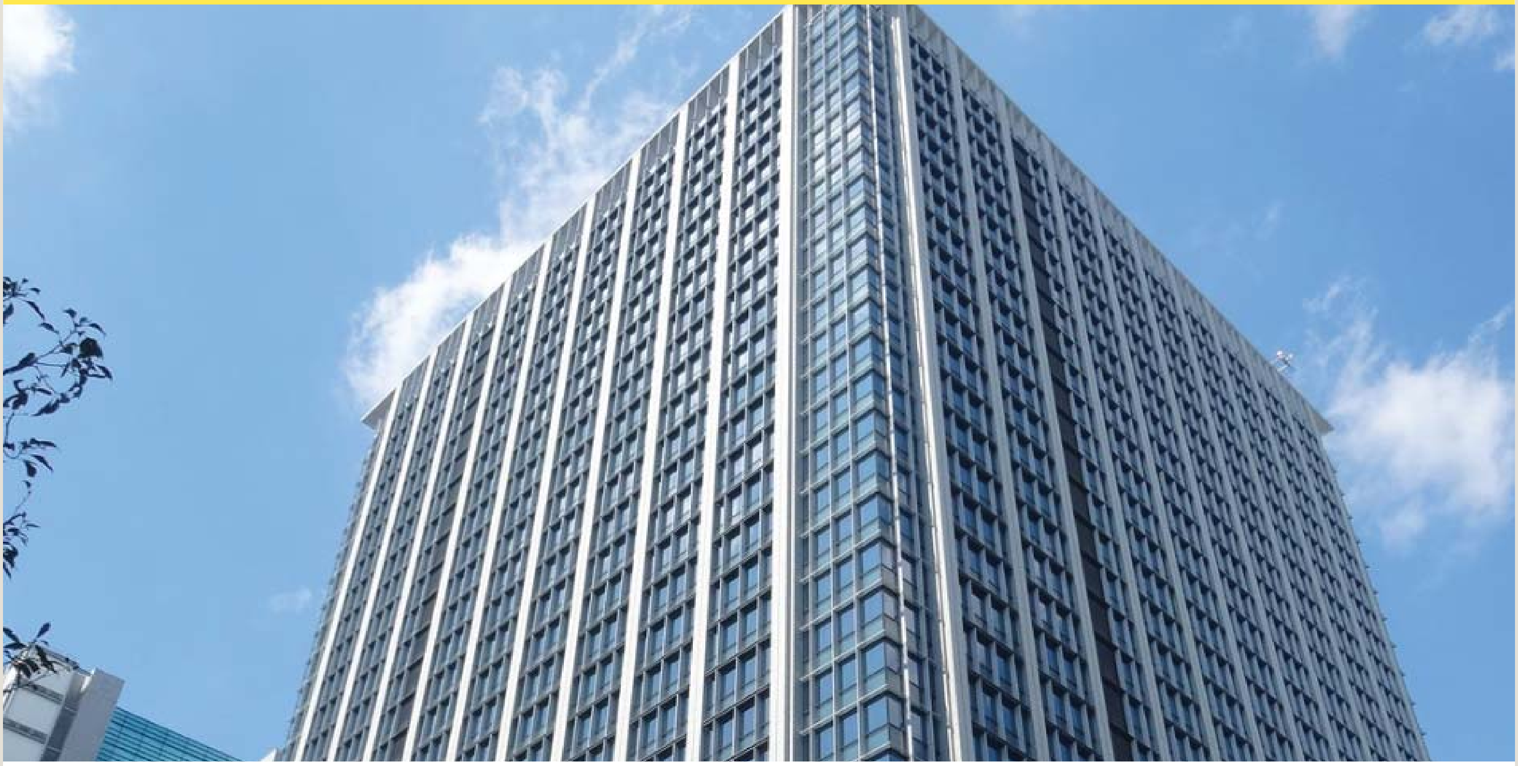


Image: Shinagawa Season Terrace, Minato Ward

SUMMARY

The improved financial market and the significantly weaker yen have bolstered corporate profitability, which could lead to business expansion and headcount growth.

- The average Grade A office vacancy rate in Tokyo's central five wards improved by 1.1 percentage points (ppts) Year-on-Year (YoY) in the first quarter to 3.6%, a marginal increase of 0.4% quarter-on-quarter (QoQ) .

- Steady momentum in the occupier market continued to support the rental recovery, with Grade A office rents increasing 1.5% QoQ and a robust 8% YoY.

- The average vacancy rate for large-scale Grade B offices similarly drifted downwards to a new cyclical low of 2.7%.

- Average monthly rents for the large-scale Grade B segment rose 2.4% QoQ and 8.9% YoY – the fastest rate of increase since the global financial crisis.

- In both the Grade A and large-scale Grade B office segments, average rents across the central five wards remain roughly 40% down from their cyclical highs in 2007.

- Nonetheless, cumulative growth since the market bottomed out in 2012 has been solid, with Grade A rents up 23% from their 2012 nadir.

"Although a substantial volume of supply has recently entered the market, average vacancy rate still continue to fall, along with certain increases in the closing rent level." Savills Research

Market summary

Grade A office segment

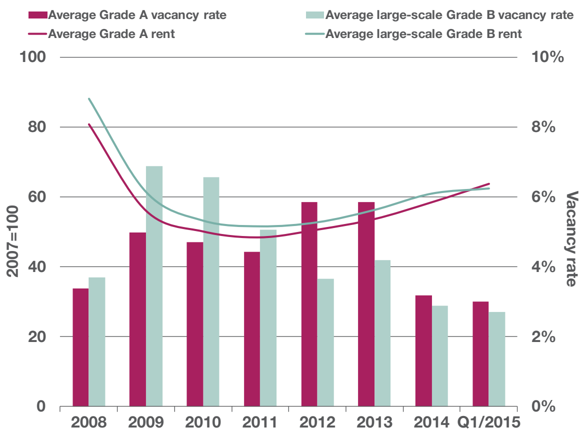
Steady momentum in the occupier market continued to support the rental recovery, with Grade A office rents in this quarter increasing approximately 8% YoY. This outpaces the healthy 7% recovery recorded in the same quarter last year. As of Q1/2015, estimated passing rents for Grade A office space have reached in the territory of JPY30,130 per tsubo[1] per month, representing a 1.5% rise over the preceding quarter and the highest figure since Q3/2009.

A steady flow of large lease agreements has dramatically reduced the amount of office space in top-grade buildings available for headquarters relocations, ie properties with whole floors for lease or vacancies across contiguous floors. This is not only benefitting the landlords of existing buildings, who are requesting higher rents for new agreements and lease renewals, but also developers in the form of pre-agreements for planned schemes and projects under construction.

1 1 tsubo = 3.306 sq m or 35.583 sq ft.

GRAPH 1

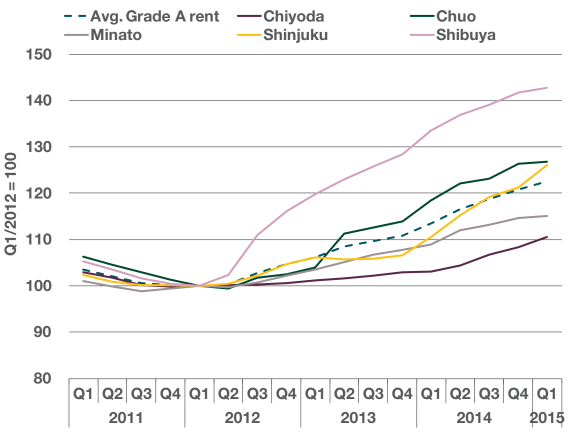
Office rent and vacancy rate trend in Tokyo's central five wards (C5W) by grade, 2008–Q1/2015



Source: Savills Research & Consultancy

GRAPH 2

Grade A office rental index by ward, Q1/2011–Q1/2015



Source: Savills Research & Consultancy

Large-scale Grade B office segment

Supported by steady occupier demand for high-quality consolidation space and property upgrades, the average vacancy rate for large-scale Grade B office[2] properties drifted downwards to another new cyclical low of 2.7%. An improvement of 0.2 ppts QoQ and 0.7 ppts YoY, this figure represents the lowest level of vacancy since Q2/2008.

Vacancy rates in this market segment have demonstrated a positive trend since early 2011, reflecting a flight to quality among tenants at the expense of older, small- to mid-scale rental buildings and outmoded owner-occupier stock. This bifurcation within the Grade B market has resulted in uncompetitive properties being removed from the market for both refurbishment and redevelopment.

Reduced levels of availability have buoyed achievable rents. The average monthly rent for large-scale Grade B properties monitored by Savills reached JPY22,870 per tsubo in Q1/2015, up 2.4% QoQ and 8.9% YoY – the fastest rate of increase since the global financial crisis.

With quarterly rental growth in the large-scale Grade B segment continuing to outpace that of Grade A in the first quarter, the rental premium payable for prime office space slipped 1.2 ppts to 31.8%. This compares with 32.7% in the first quarter of last year and a cyclical low of around 25% in 2009.

Savills monitors rents and vacancy levels at more than 300 buildings located in Tokyo's central five wards with a GFA of 10,000 sq m or above. Unlike similar market information issued by other research institutions, the rental data provided relates to estimated passing rents, inclusive of common area management fees, as opposed to asking rents. Meanwhile, vacancy figures reflect current vacant space without the inclusion of 'expected' vacancy, or that reported prior to tenants vacating their premises. As a consequence, benchmark figures, particularly vacancy rates, tend to be lower than other market indices.

2 Grade B office refers to buildings with a GFA of 15,000 sq m (4,500 tsubo) with a building age of less than 25 years. Some buildings are included that do not fit this definition.

The rent recovery story – where has growth been focused?

In both the Grade A and large-scale Grade B office segments, average rents across the central five wards remain roughly 40% down from their cyclical highs of 2007. Nonetheless, cumulative growth since the market bottomed out in 2012 has been solid. This is particularly true of Shibuya and Chuo wards, where a confluence of low-market vacancy rates and landmark building completions supported rents in 2012, and 2013 when growth in the other major submarkets was dampened by pockets of oversupply.

Taking the rental nadir of Q1/2012 as an indexed value of 100, Graph 2 below demonstrates that average Grade A rents in Tokyo have improved further with a rise of approximately 22%. Shibuya has again outpaced the market, reaching a value of 143, followed by Chuo at 127.

On the back of its dramatically improved occupancy situation, Shinjuku continued to record the fastest rate of growth of the five wards in the first quarter 2015, with approximately 14% YoY growth, to sit above the wider-area average (C5W), at an index value of 126.

Minato and Chiyoda wards – Tokyo's largest office submarkets in terms of stock – have posted a moderate rate in term of recovery. Grade A rents here stand at 115 and 111, respectively, from the benchmark low of 2012. However, with vacancy rates falling and a stable pre-commitment condition for new supply coming on line over the year ahead, the rate of growth in these two submarkets is expected to remain steady in a long run.

Grade A rents and vacancy rates by ward

Chiyoda

The average Grade A vacancy rate in Chiyoda continued to lead the positive trend to reach 1.7% rate in the first quarter – its lowest level since Q3/2008. This figure represents in-movement of 1.0 ppts over the quarter and 2.5 ppts YoY.

Notable leasing activity has involved companies from sectors including ICT, business services and financial services and manufacturing. Grade A office passing rents in Chiyoda Ward averaged approximately JPY37,010 per tsubo in Q1/2015, up 2.0% QoQ or 7.2% YoY.

Reflecting its status as Tokyo's most expensive office location, Chiyoda maintains a strong rental premium relative to the five-ward average. Nonetheless, faster rates of growth in the other wards have resulted in this premium being reduced from around 36% at the bottom of the market in early 2012, to approximately 23% in Q1/2015.

Chuo

Chuo Ward's average Grade A vacancy rate strengthened to 2.5%, an improvement of 0.4 ppts QoQ and 2.6 ppts compared to the same quarter of last year. Leasing activity here involved companies from sectors such as insurance, ICT and financial services.

The average Grade A passing rent in Chuo Ward stood at JPY27,500 per tsubo, up 0.4% QoQ and 7.1% YoY.

Minato

The Grade A vacancy rate improvement in Minato was 6.1% during the first quarter of the year. This is as a result of the entry of Shinagawa Season Terrace, a high-rise office in the Konan area. The pre-commitment activity was reportedly lagging at around just 25% when the building was completed, leaving some of the floors temporarily vacant until new tenants occupied the available space. When provisionally discounting the newly completed building from the portfolio of property in Minato Ward, the vacancy rate sits as low as 2.9% for Q1/2015.

Regardless of the increase in new space available, Minato Ward still recorded a modest improvement of 0.2 ppts YoY, reflecting a solid demand in the area.

In addition to the small- to mid-sized lease agreements recorded at existing buildings, sizable leases were reported at buildings currently under construction. These include Japan Patent Office's (JPO) relocation plan for its headquarters from Kasumigaseki to the tentatively-named Sumitomo Fudosan Roppongi San-Chome East Area Project. This high-rise office building is located on the site of the former IBM Japan Headquarters Building and other buildings, with completion set for early 2016.

The average Grade A office rent in Minato recorded a marginal growth of 0.4% QoQ for a tenth consecutive quarter. It reached JPY29,190 per tsubo, up 5.7% YoY.

Shibuya

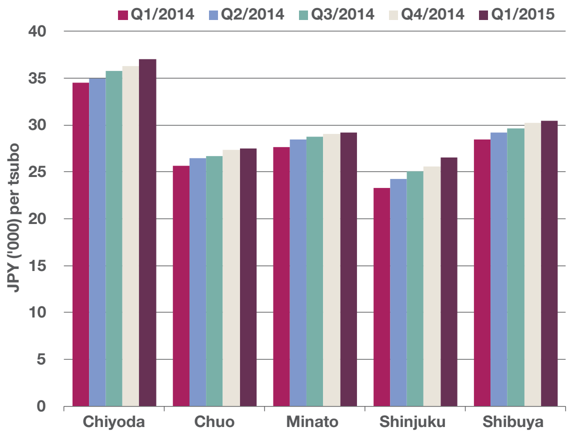
Shibuya's average Grade A vacancy rate edged down to 0.6 ppts over the quarter to 3.5%, but sits 1.5 ppts higher than the same period a year ago as a result of modest absorption for the secondary space, which was released back to the market in the Ebisu district.

Even so, with a limited number of prime buildings available for rent in this submarket comparative to the other wards, the balance remains on the side of the landlords. Average Grade A rents increased 0.6% QoQ to JPY30,420 per tsubo, up for a thirteenth consecutive quarter taking the annual growth rate to 6.9%.

As a result of steady increases in its average Grade A rent since 2012, Shibuya became Tokyo's second most expensive ward in Q4/2013, and still maintained a slight lead over third-place Minato in Q1/2015.

GRAPH 3

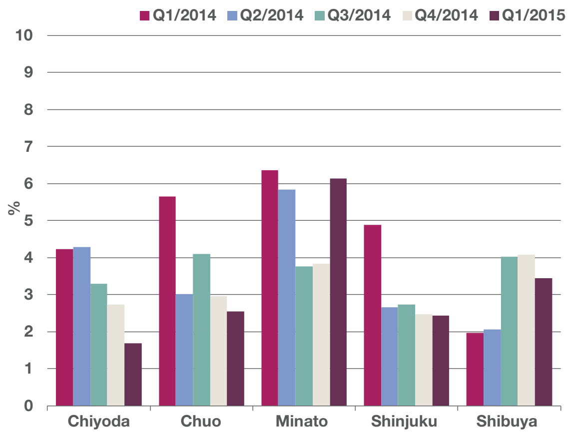
Average Grade A office rents by ward, Q1/2014–Q1/2015



Source: Savills Research & Consultancy

GRAPH 4

Average Grade A office vacancy rates by ward, Q1/2014–Q1/2015



Source: Savills Research & Consultancy

Shinjuku

Shinjuku's average Grade A vacancy rate sustained its positive trend for a seventh consecutive quarter, edging down 0.1 ppts QoQ to 2.4%. This represents an improvement of 2.5 ppts YoY and follows the particularly strong absorption of large vacancies in the early 2014.

Shinjuku recorded the highest rate of Grade A office rental growth having risen double-digits YoY at 13.9% to JPY26,550 per tsubo in the Q1/2015. Movement over the preceding quarter was a healthy 3.9%.

TABLE 1

Notable office leasing transactions, Q1/2015

Company	Business sector	Type	Former building(s)/location	New building(s)/location	Approximate space taken	
					tsubo	sq m
Japan Post Insurance	Insurance	Consolidation	Multiple, incl. Tokyo Service Center / Minato Ward	Osaki Bright Tower* / Shinagawa Ward	16,000	52,900
Japan Patent Office (JPO)	Legal services	Headquarters relocation	JPO Government Building / Minato Ward	Sumitomo Fudosan Roppongi San-Chome East Area Project* / Minato Ward	6,300	20,800
Six companies of Shinsei Bank group	Financial services	Headquarters relocation/ consolidation	Multiple, incl. Swan Tokyo Building / Chiyoda Ward	Sumitomo Fudosan Akihabara Building / Chiyoda Ward	2,900	9,600
Kyowa Hakko Kirin, Kyowa Hakko Bio	Pharmaceutical	Headquarters relocation/ consolidation	Otemachi Building / Chiyoda Ward	Otemachi B-2 Block Redevelopment Building A* / Chiyoda Ward	2,540	8,400
TechMatrix	IT Consultant	Headquarters relocation/ consolidation	Multiple, incl. Keikyu No.7 Building / Minato Ward	Kokusai Kogyo Mita No.2 Building / Minato Ward	2,000	6,700

Source: Savills Research & Consultancy
* Buildings under construction

OUTLOOK

The prospects for the market

Tokyo's Grade A office development pipeline for 2015 is weighted heavily towards the first half of the year, where a substantial volume of new office space has entered the market. This was brought by two major new projects – Shinagawa Season Terrace in Minato Ward and Tokyo Nihombashi Tower in Chuo Ward. With a stable pre-commitment trend, the average vacancy rate shall continue to improve, along with certain increases in the closing rent level.

The improved financial market and the significantly weaker yen have bolstered corporate profitability, which will lead to business expansion and headcount growth, especially within export-oriented firms. The improved business environment and performance has led to numerous announcements of wage increases by top tier firms, which will spread to their subsidies and re lated companies.

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